

Determinants and Causes of Low Foreign Direct Investment in Pakistan

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Abstract: This paper analyzes the determinants and causes of low foreign direct investment in Pakistan and examines why Pakistan have been relatively unsuccessful in attracting FDI. The time series data from the period 1990-2014 is used. Regression model is run to check the significance of the data and relationship between dependent and independent variables. GDP, Gross Capital Formation (GCF), Inflation rate, Indirect taxes are taken as independent variable and FDI as dependent variable. The study reveals that Pakistan has small GDP and it is not growing at a higher rate, inflation is high and taxes are increases day by day 1which are the main causes of low FDI in Pakistan.

Introduction:

Foreign direct investment (FDI) is a key element for developing countries to increase their economic growth. FDI inflow is the investment made by the non- resident investor in the host country. And FDI outflow are the investment which made by the host country into other country. it is a key driver of employment, productivity improvement and ultimately economic growth. FDI has some inherent advantages such as risk sharing, export orientation, transfer of technology and managerial expertise. The host country can increase the level of FDI by doing liberalization through tax concession, reduction in tariff rates and providing subsidies to industries. Those policies give incremental growth to FDI in developing countries like Pakistan. To attract FDI the host country should develop friendly policies and stable infrastructure for the investors. Political factors show the continuity of the governmental policies that are closely related to stable political environment. Instable political environment along with frequent changes in the ruling regime indicate inconsistencies in governance and reflecting possible negative effects on business activities in the host country. That country which shows uncertainty in their policies, investors hesitate to invest in it.

This paper examines the factors that causing to decrease the level of FDI in Pakistan. This is done by taking some of variables that are affecting FDI in different ways and run the regression analysis over the data from 1990 to 2014. And the results shows that how these variables will affect the growth of FDI in Pakistan

Objectives of study:

- To examine the relationship between FDI and inflation.
- To investigate the impact of FDI on GDP per capita.
- To analyze the impact of tax rate on FDI level.
- To explain the relationship between FDI and gross capital formation.

Problem statement

Foreign direct investment plays a vital role in the economy of Pakistan, because due to inflow of FDI many new projects started, employment level increased and overall economy of the country grows. FDI is especially important for those countries where financial markets are not fully developed.

But in the last few years foreign direct investment has been decrease due to non attractive investment policies of the government.

FDI has showed a declining trend since 2007-08, which is due to the lack of enabling environment for investment in the country. The document indicates that Pakistan secured \$3.52 billion in FDI in 2005-2006. FDI grew to \$5.14 billion in 2006-2007, then \$5.41 billion in 2007-2008. However, with the issue of terrorism, its FDI level dropped to \$3.72 billion in 2008-2009. As terror attacks increase investment continued decline to \$1.72 billion in 2009-2010. (World development indicator)

In our study we determine or figure out the issues and factors which are responsible for decrease in FDI. And show where government needs to strength their rules and regulations.

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LITERATURE REVIEW:

1.Khondoker and Kaliappa (2010) reported that countries with larger GDPs, higher GDP growth rates, higher proportion of international trade and a more business-friendly environment are more successful in attracting FDI.

2.Sufiyan and Moise (2010) concludes that, countries that are receiving fewer foreign investments could make themselves more attractive to potential foreign investors. So, the policy makers in the MENA region should remove all barriers to trade, develop their financial system.

3.Obida Gobna and Abu Nurudeen (2010). Study reveals that the market size of the host country, deregulation, political instability, and exchange rate depreciation are the main determinants of low foreign direct investment in Nigeria.

4.Nomathemba,Garrick and Ralph (2010) declared The results indicate market size to have a positive impact on FDI flows under all specifications a result consistent with earlier studies. while greenfield investments are seen to respond more to the growth potential of the market relative to other forms of investment. In general, we find macroeconomic variables to be poor at explaining project-level FDI in the region.

5.Monica and Akshy (2011) was found that of all macroeconomic variables taken, only GDP, inflation rate and scientific research are significant and that FDI Policy changes during years 1995-1997 have had a significant impact on FDI inflows into India.

6.Results suggest cost related, macroeconomic factors and cumulative risk index variables are the major determinants emerged in short-run analysis. The results also suggest long run relationships among FDI, openness and macro economic factors consistently. Openness emerges as dominant factor in long run dynamics.. (**Ahmad and Ithkiar 2011**)

7.Fayyaz and Constance (2012) finds that market size is the most important determinant of foreign direct investment to developing countries. Further, stable macroeconomic environment, global integration, availability of skilled labor force and developed financial sector also promote foreign direct investment in developing countries

8. results describe that fixed effects estimation indicates that market size, labor cost and quality of infrastructure yield significant coefficients in relation to FDI for the panel of countries under study. A bi-directional short-run relationship is established between market size and labor costs in the short-run; whereas quality of infrastructure causes market size and labor costs in the short-run. For the long-run deviation of FDI from equilibrium, market size, labor costs and quality of infrastructure all bear the joint burden in the short-run to re-establish the equilibrium (**Abdullah and Syed Zulifqar 2013**)

9. Hina et al (2013) examines the effect of human capital on the inflow of foreign direct investment (FDI) in Pakistan by using regression analysis over 1975–2007. The findings of this study and literature on human capital as a determinant of FDI indicates that human capital is an important determinant of FDI and for the developing countries seeking to attract higher value-added FDI, it is necessary to upgrade human capital.

10. a panel data estimator suggests that the market size, total reserves, infrastructure and labour costs are the main determinants of FDI inflows to developing countries. (**Khachoo et al 2012**)

11. The determinants of FDI are examined for inward direct investment function, framework. The most important factors appear to be trade openness, wages and the quality of labour in the country. Size of the market is reported to have a lesser impact on FDI, probably related to the limited size of the population and the domestic market on the one hand and the good export opportunities from Mauritius on the other. (Seetanah, 2011)

12. Author investigated the impact of FDI on economic growth in Pakistan. They use three variables such as trade openness, political instability and terrorist attacks. They take the data during 1972-2012. Least square method has been applied to check the effect of these variables on GDP of Pakistan. The results show that FDI has positive significant effect on economic growth of Pakistan. (Nayyira et al 2014)

Methodology:

For the purpose of research we use secondary data 1990-2014 taken from the world development indicators (WDI) for the analysis of data used regression model. (John C. Anyanwu 2012)

And the variables of this study are:

FDI = Foreign Direct Investment Inflow

TAX= taxes

GDP = Gross Domestic Product

INF = Inflation

GCF = Gross Capital Formation

$$FDI = B_1 + B_2INF + B_3GCF + B_4GDP + B_4TAX$$

Specification of variable:

Foreign direct investment inflow (FDI) is used as dependent variable. The data is taken from world development indicators (2015)

Inflation (INF) consumer price index is use to measure the inflation rate of Pakistan. And (WDI) is a big source of consumer price index

Gross capital formation (GCF) is very important factor and data is taken from world development indicators (WDI) 2015

Gross domestic product (GDP) world development indicators are used to collect data of GDP current us

TAXES (TAX) is taken from world development indicators (2015)

Dependent variable=FDI
 Sample observation= 25
 Method=least square regression

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	
	B	Std. Error	Beta			
1	(Constant)	-4013464219.665		-1.436	.167	
	INF	33938310.871	61890939.926	-.089	-.548	.590
	GCF	595591471.293	167155093.966	.688	3.563	.002
	GDP	.020	.005	.787	3.745	.001
	taxes	-769081157.519	289920963.093	-.374	-2.653	.016

a. Dependent Variable: FDI

$$FDI = 5761520314.49 - 33938310.871INF + 595591471.393GCF + .020GDP - 769081157.519TAX$$

Results and interpretation:

In this investigation on determinants and causes of low foreign direct investment in Pakistan, i apply regression analysis to find the relationship and significance of all independent variables on FDI.(Oyatoye, foreign direct investment, export and economic growth in nigeria , 2011) (Anyanwu, Why does foreign direct investment go where It goes?: new evidence from african countries , 2012) (Nurudeen, Determinants of foreign direct investment:the case of nigeria, 2011) (Abbas, Impact of foreign direct investment on gross domestic product (A Case of SAARC Countries), 2011) also use regression in their investigation of determinants of FDI.

The model concluded a negative impact of inflation on FDI. But statistically insignificant due to secondary data. It depicts that one unit increase in inflation will cause -33938310.871 units decrease in FDI. Because high inflation decreases economic activity and that will cause decrease economic growth. So there will be negative relation of inflation and FDI.

Gross capital formation is taken as independent variable in this investigation. It shows positive relationship with FDI and statistically significant. It means one unit increase in GCF will cause 595591471.293 units increase in FDI of host country.

GDP is taken as independent variable in this investigation. It shows positive relation and statistically significant. That one unit increase in GDP will cause .020 units increase in FDI. (Oyatoye, foreign direct investment, export and economic growth in Nigeria, 2011). (Abbas, Impact of foreign direct investment on gross domestic product (A Case of SAARC Countries), 2011) also shows positive relation of GDP on FDI in their investigation.

Taxes are also taken as independent variable in this investigation, which shows negative relation with FDI but statistically insignificant due to multicollinearity. Model shows when one unit increase in taxes there will be 769081157.519 units decrease in FDI.

Conclusion

I have read more than twenty articles on FDI while making this research. In these articles the most important independent variables were used GDP, GCF, TAXES, INFLATION RATE. According to theory there is positive relationship between GDP and FDI. With an increase in GDP the FDI also increases. I examined this variable in the case of Pakistan by taking the secondary time series data 1981-2010 and found the same positive relationship.

According to theory the GFCF has also a positive relationship and my model also shows the same positive relationship. The studies regarding FDI tell that there is negative relationship between Taxes and Inflation rate in the country. An increase in these variables would decrease the FDI. In the case of Pakistan the model shows also negative relationship between these independent variables and dependent variable FDI. But the values are not statistically significant, it may be due to secondary data or there can be a problem of multicollinearity in the model. But the results are according to theory and studies which I have read during this research paper.

The study concluded that a number of factors are responsible for low FDI in Pakistan. The slowing down of economic activity together with inconsistent economic policies has also discouraged foreign investors to invest in Pakistan. Now a day's Pakistan is facing another sever problem of power shortage. It is not only ruing the domestic industry but also discouraging the foreign investors, because nobody wants to invest in an unstable country. The GDP of Pakistan is low, the inflation rate is increasing day by day, and the exports have been decreased. These all factors are the major reasons of low FDI in Pakistan.

Recommendations

To attract the FDI government should overcome the problem of power shortage and improved law and order situation in the country foreign investors in Pakistan have to cope with a complex legal situation. The law and regulations should be simplified, updated and made more transparent. There is urgent need to reduce the number of taxes, administrative procedure and most importantly reduce the contact of foreign firms with a large number of taxes and contribution collecting agencies.

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